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IN THE

Supreme Court of the United States

OCTOBER TERM, 1957

No. 417

WILLIAM EPSTEIN, *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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INDEX

	Page
Opinion below	1
Jurisdiction	2
Questions presented	2
Statute involved	3
Statement	3
Reasons for granting the writ	11
Conclusion	32
Appendix:	
A—Cause Argued and Submitted	1a
B—Judgment Below	1a
C—Opinion Below	2a
D—Order Extending Time to File Petition for Writ of Certiorari	15a
E—Tennessee Public Acts, 1937, Chapter 185, Sections 6 and 17	16a
F—Tennessee Public Acts, 1949, Chapter No. 205	16a
G—Exhibits:	
(1) Exhibit 1 to Defendant's witness Deutsch entitled "William and Pearl Epstein—Net Worth Reconciliation 12/31/48—12/31/52"	17a
(2) Exhibit 5 to Government witness Norris entitled "William and Pearl Epstein, Condensed Net Worth Determination of Net Income for years ending December 31, 1948 to December 31, 1952"	18a
(3) Exhibit 8 to Government witness Norris entitled "Disposition of Corrected Net Income per Indictment"	19a
(4) Exhibit 10 to Government witness Norris entitled "Average Combined Income of Epsfein's Loan Office and Sales for periods 1945 to 1948 and 1949 to 1952"	20a

Page

(5) Exhibit 11 to Government witness Norris entitled "Application of Total Available Income for period 1920 to 1948, Inclusive" .. 20a

CITATIONS

CASES:

Boyd v. *United States*, 142 U.S. 450 (1892) 29
Dupree v. *United States*, 218 F. 2d 781 (5 Cir., 1955) 20
Hasson v. *Commissioner*, 239 F. 2d 778 (6th Cir., 1956) 13
Holland v. *United States*, 348 U.S. 121 (1954) 11, 12, 14, 15, 17, 18, 19, 22, 24, 27, 28, 29, 31
Johnson v. *United States*, 318 U.S. 189 (1943) 29
Kashat v. *Commissioner*, 229 F. 2d 282 (6th Cir., 1956) 13
Lovely v. *United States*, 169 F. 2d 386 (4th Cir., 1948) 30, 31
Massei v. *United States*, 241 F. 2d 895 (1st Cir., 1957); certiorari granted, 352 U.S. 1000 (1957) 2, 13, 14 18, 30, 31
Smith v. *United States*, 348 U.S. 147 (1954) 12, 15, 19, 27
Spies v. *United States*, 317 U.S. 492 (1943) 29, 31
Thomas v. *Commissioner*, 232 F. 2d 520 (1st Cir., 1956) 13, 17, 18, 19
United States v. *Calderon*, 348 U.S. 160 (1954) .. 12, 15
United States v. *Ford*, 237 F. 2d 57 (2d Cir., 1956); certiorari granted, 353 U.S. 964 (1957) 2, 13, 14

STATUTES:

Internal Revenue Code of 1939, Section 145(b); 53 Stat. 62 (1939), 26 U.S.C. 145(b) (1952 ed.) 1, 3

MISCELLANEOUS:

Petition for Certiorari, *United States* v. *Massei*, No. 885, October 1956 Term 13
Rule 75(1) of the Federal Rules of Civil Procedure 4
Rule 39(b)(1) of the Federal Rules of Criminal Procedure 4

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WILLIAM EPSTEIN, *Petitioner*

v.

UNITED STATES OF AMERICA, *Respondent*

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

Petitioner prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Sixth Circuit affirming petitioner's conviction under section 145(b) of the Internal Revenue Code of 1939.

OPINION BELOW

The opinion of the Court of Appeals is not yet officially reported and is printed in Appendix C hereto, *infra*, p. 2a.

JURISDICTION

The judgment of the Court of Appeals (Appendix C, *infra*, p. 2a) was entered on July 2, 1957. The time for filing this petition was extended to August 31, 1957, by an order of Mr. Justice Brennan dated July 24, 1956 (Appendix D, *infra*, p. 15a). The jurisdiction of this Court is invoked under 28 U.S.C., § 1254 (1952 ed.).

QUESTIONS PRESENTED

This case presents three questions.

The first question is whether the Government, in a criminal prosecution for tax evasion based on the net worth method, must prove a likely source of income to establish that the net worth increases are properly attributable to unreported taxable income, there being no evidence of specific tax evasion or of concealment or destruction of records. The same question is also involved in *United States* v. *Ford*, 237 F. 2d 57 (2d Cir. 1956) and *Massei* v. *United States*, 241 F. 2d 895 (1st. Cir. 1957). This Court has already granted certiorari in both these cases. See 352 U.S. 1000 (1957); 353 U.S. 964 (1957). The present case submits this question in a more searching form and in a factual and legal setting of more general applicability than the *Massei* and *Ford* cases.

The second question is whether the Government has conformed to the standards of proving opening net worth and the existence of unreported taxable income which this Court has established for prosecutions based on the net worth method.

The third question is whether in a prosecution for tax evasion the jury may infer willfulness from the

defendant's unrelated omission of income in pre-prosecution years. Essentially the same question is involved in the *Massei* case.

STATUTE INVOLVED

Internal Revenue Code of 1939, Section 145(b); 53 Stat. 62 (1939), 26 U.S.C. 145(b) (1952 ed.)

* * * * *

> (b) Failure to Collect and Pay Over Tax, or Attempt to Defeat or Evade Tax.—Any person required under this chapter to collect, account for, and pay over any tax imposed by this chapter, who willfully fails to collect or truthfully account for and pay over such tax, and any person who willfully attempts in any manner to evade or defeat any tax imposed by this chapter or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than $10,000, or imprisoned for not more than five years, or both, together with the costs of prosecution.

* * * * *

STATEMENT

On February 21, 1956, petitioner was indicted in four counts in the Western District of Tennessee for willfully attempting to evade his income taxes for the years 1949 through 1952. He and his wife filed joint tax returns for these years. Petitioner was charged with having omitted an aggregate income of $146,940.25, on which aggregate taxes of $74,004.23 were allegedly due. The net income and resulting taxes, as reported

by petitioner and revised by the Government, were as follows (R. 48a, 234a-235a, 91b-92b, 100b):[1]

Year	Reported Net Income	Tax	Revised Net Income	Tax
1949	$20,105.62	$ 4,278.96	$60,633.24	$22,844.03
1950	37,142.46	11,225.82	66,358.55	26,874.35
1951	16,526.59	3,866.31	69,325.84	32,303.39
1952	14,395.12	3,492.62	38,792.41	14,846.17

After a jury trial, based entirely on the net worth method of proof, petitioner was found guilty on all four counts. He was sentenced to imprisonment for five years on each count, the terms to run concurrently, and he was fined a total of $25,000 on the four counts (R. 256a).

The relevant evidence may be summarized as follows:

Petitioner was born in 1894 (R. 118a). In 1912 he went to work in a pawnshop in Memphis, Tennessee (R. 118a). By 1924 he and his wife had accumulated about $63,500 from employment and business ventures (R. 119a, 123a). In that year he opened his own

[1] In accordance with the rules of the court below promulgated under Rule 75(l) of the Federal Rules of Civil Procedure, and Rule 39(b)(l) of the Federal Rules of Criminal Procedure, petitioner, in the proceeding below, filed an Appendix designated "Appendix to Appellant's Brief". The Government also filed an Appendix designated as "Appendix to Appellee's Brief". These two Appendices have been certified to this Court in accordance with Rule 21(3). Page references to petitioner's Appendix below will be made in the following manner: (R. —a). Page references to the Government's Appendix below will be designated (R. —b). The exhibits referred to have all been certified to this Court, and in accordance with the District Court procedure are designated separately in numerical sequence with reference to the direct or cross-examination of particular witnesses.

pawnshop and a retail sales store (R. 120a). The two businesses were in the same building and were connected by a door (R. 122a).

On May 30, 1937, the Tennessee legislature enacted a statute prohibiting pawnbrokers from conducting any other business in the same or in an adjoining building (Appendix E, *infra*, p. 16a; R. 121a, 129a). On advice of his attorney, petitioner sealed the opening between the two stores and placed the sales shop in the name of J. P. Kirschner, his stepfather-in-law (R. 31a-32a, 64a, 121a-122a, 129a-130a, 197a; Coll. Ex. 21 to Davis). While title to the store was in Kirschner, petitioner continued to manage it as before (R. 122a, 130a). He made the purchases and paid the bills (R. 31a-32a). Mrs. Epstein worked in the sales store and was the only person authorized to draw checks on the store (R. 114b). Kirschner had nothing to do with the operation of the store (R. 63a, 64a, 122a). Both petitioner and the revenue agents agreed that petitioner owned the profits of the store (R. 63a-65a).

The sales store was operated in this fashion until April 14, 1949, when the restrictive legislation was repealed (Appendix F, *infra*, p. 16a; R. 122a, 129a). Petitioner then promptly reassumed title to the sales shop and reopened the door connecting it to the pawnshop (R. 65a-66a, 129a, 130a, 210a, 84b, 120b).

For the period of operation in Kirschner's name—from 1937 until 1949—petitioner, on advice of counsel, kept separate books and records for the sales shop and arranged for Kirschner to file separate tax returns for the sales business (R. 8a, 17a, 64a-65a, 122a, 197a-198a).

The total income reported on the Kirschner returns for the sales shop operation, 1937-1949, was $129,339.14; the total tax paid was $29,837.07; and the net proceeds after tax were $99,502.07 (R. 122a, 125a). After the pawnshop and the sales store were consolidated, following repeal of the restrictive legislation, petitioner again reported the income from both businesses on his returns jointly filed with his wife (R. 65a, 130a, 13b).

Before 1948 petitioner and his wife filed separate returns. For the years 1948 through 1952 they filed joint returns (R. 8a, 122a, 3b-4b).

Throughout the prosecution period of 1949 to 1952, petitioner regularly maintained records for the pawnshop and sales shop. A public accountant was in charge of his books (R. 7a-8a, 13a, 15a, 163a, 165a, 121b). The books showed receipts, purchases, and other expenses (R. 14a).[2] All loans were made in cash (R. 165a, 122b). Each loan could be checked because petitioner recorded each loan pursuant to a local ordinance (R. 165a-166a, 177a-178a, 122b). Petitioner had to furnish the police department a daily report of his loans and redemptions (R. 165a-166a, 178a, 122b). A special pawnshop detail of the department checked his records several times a day (R. 165a-166a, 177a-179a). Petitioner fully cooperated with the police, and, as police officials testified, they were entirely satisfied

[2] At the trial there was some difference of opinion whether most of the expenses were paid in cash or by check (R. 164a, 13b, 80b, 121b). This variety of view is rather unimportant, for the additional income constructed by the Government is attributed to alleged unreported receipts from sales and interest on loans. There is no dispute over the expenses deducted by petitioner (R. 56a-57a).

that his records were correct (R. 177a-178a, 180a, 182a). There is no evidence that the Government investigated these records. The Government conceded that petitioner's inventory figures were "true" (R. 131a-132a). The revenue agents never investigated or evaluated the inventory records in order to check the accuracy of the volume of sales reflected on petitioner's books (R. 195a).

Petitioner's returns for 1949 through 1952 accurately reflected the books and records of both businesses[3] (R. 7a-8a, 13a). In 1949 the Government audited his 1946 return and found nothing wrong with his system of entries (R. 126a). The Government conceded that his returns for 1949 through 1952 correctly reported his income from all sources, except that it assumed his returns were not complete as to his business receipts consisting of interest on loans and proceeds from sales (R. 56a-57a, 142a)[4].

According to the undisputed evidence, petitioner's books were adequate under the regulations (R. 8a-9a, 18a, 28a-29a, 36a, 164a). The record does not show a single instance of failure to record receipts or of false entry. The only criticism of petitioner's records was the statement by revenue agents that cash transactions could not be verified (R. 13a, 80b).

In order to prove its case, in the absence of any specific evidence of tax evasion, the Government pro-

[3] Revenue agent Huddleston testified that "the figures on the returns did agree with the books and records that he gave me" (R. 13a).

[4] Petitioner's other sources of income in the prosecution years were real estate, stockholdings, and partnership interests (R. 56a-57a, 142a).

ceeded by the net worth method (R. 227a-228a).[5] It started with an opening net worth of $246,839.63 as of December 31, 1948 (R. 97b; Ex. 5 to Norris, Appendix G(2), *infra*, p. 18a). On the basis of this premise the Government constructed annual increases in net worth for the prosecution years in amounts greatly exceeding petitioner's reported net income for those years (R. 97b-100b; Ex. 5 to Norris, Appendix G(2), *infra*, p. 13a). Accordingly, it "reconstructed" petitioner's net income for each of the years (See table, *supra*, p. 4). As reconstructed, the net income attributed by the Government to petitioner's businesses for each of the years except 1952 was substantially greater than his net income from the same sources for any pre-prosecution year, though petitioner's businesses had not changed.[6]

The Government credited petitioner with an opening net worth on December 31, 1948, of $246,839.63, including $20,000. as total cash for petitioner and his wife (R. 51a-52a, 93b, 96b; Ex. 5 to Norris, Appendix G(2), *infra*, p. 18a). The court below states that this figure "went back to defendant's bank statement for December 31, 1946," showing cash on hand and in bank of $21,740, of which $19,546 was cash on hand (R. 52a).

The only direct evidence in the record of petitioner's cash on December 31, 1948, or from December 31, 1946,

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[5] The court below stated that petitioner's accountant, Jones, agreed that this was the proper method. Jones did not testify. The court is apparently relying on a statement by revenue agent Norris purporting to report Jones' alleged statement (R. 77b).

[6] Petitioner's highest pre-prosecution net income was $43,266.06 in 1942, compared with the attributed annual net income for 1949-1951 in excess of $60,000.

to December 31, 1949, is petitioner's evidence that on December 31, 1948, he had $129,855.84 in cash, consisting of $27,116.02 belonging to his wife, $82,739.82 accumulated from the Kirschner operation, and $20,000 belonging to himself (Exhibit 1 to Deutsch, Appendix G(1), *infra*, p. 17a; R. 207a). The Government made no allowance for the wife's cash or the cash from the Kirschner operation. (Exhibit 5 to Norris, Appendix G(2), *infra*, p. 18a).

The Government attempted to support its figure of $20,000 cash by (a) statements made by petitioner to the Union & Planters Bank & Trust Co. as of February 2, 1945; December 31, 1946; December 31, 1949; and January 1, 1952; (b) Dun & Bradstreet reports reflecting these statements (R. 22a-23a, 25a, 52a-54a, 72a-73a, 29b-30b, 100b-101b); and (c) oral statements made by petitioner to the revenue agents in 1955, (i) which, without relating to any specific time, indicated that petitioner had cash of $6,000 or $8,000 "in his business" (R. 77a); (ii) which, in response to questions as to the amount of cash petitioner had "in his business" in 1948, referred to $25,000 or $20,000 (R. 41a); and (iii), which, in response to questions concerning the largest amount of cash he had, mentioned $35,000 or $40,000 (R. 15a, 41a).

As to the bank and Dun & Bradstreet statements, the Government conceded that petitioner did not include all his assets or any of his wife's assets (R. 108a-113a, 126a, 185a, 24b). In regard to these statements, petitioner explained that they did not include his wife's cash because they related only to his own individual assets (R. 78a, 108a-109a, 114a-115a, 141a-142a, 203a-204a), and that he had regularly excluded the Kirschner earnings because they consisted of cash

accumulated in a business from which he had formally divorced himself (R. 78a, 108a-109a, 203a-204a). As narrated above, until April, 1949, the Kirschner operation was conducted separate from petitioner's pawnshop. See p. 5, *supra*.

The revenue agents made no attempt to check the completeness of any of the statements with the bank officials (R. 117a, 186a).

Petitioner had a vault in his pawnshop where he always kept large sums of cash (R. 15a, 39a-40a, 122a, 128a, 176a-177a, 181a, 195a-196a). He required large sums in his loan business (R. 15a, 196a). He had unsuccessfully sought to insure about $125,000 to $150,000 of cash (R. 27a-28a, 201a, 35b-36b).

The Government offered no proof that petitioner's businesses were a likely source of, or capable of producing, income greater than the income reported by petitioner or approximating the alleged income attributed to the businesses. (Cf. R. 143a-148a). The only direct evidence on the earnings of petitioner's businesses in the prosecution years indicated that they had dropped off considerably from the level reached during and immediately after the war (R. 146a, 166a. 188a, 190a).

Petitioner moved for acquittal on the grounds, *inter alia*, that the Government had not shown a likely source of unreported income, had not established the opening net worth, and had not proved willfulness (R. 155a-160a). The motion was overruled (R. 161a, 213a).

The jury returned a verdict of guilty as charged (R. 255a). Petitioner was sentenced to imprison-

ment for five years on each count, the sentences to run concurrently, and fined $25,000 (R. 256a). An appeal was taken to the Court of Appeals for the Sixth Circuit, and on July 2, 1957, the Court of Appeals affirmed the judgment of conviction.

REASONS FOR GRANTING THE WRIT

This case presents three significant questions in the administration of the income tax laws and in the administration of the criminal law. These questions relate to (1) the necessity of proof of a likely source of unreported taxable income where proof is by the net worth method and no specific instances of tax evasion are involved; (2) the method of proving the existence of unreported taxable income and of opening net worth; and (3) the method of proving willfulness or intent to evade the payment of taxes.

I.

In *Holland* v. *United States*, 348 U.S. 121 (1954), this Court declared that the net worth method of proof "is so fraught with danger for the innocent that the courts must closely scrutinize its use." *Id.* at 125. The method involves "something more than the ordinary use of circumstantial evidence in the usual criminal case." *Id.* at 124. As the Court thoughtfully emphasized, juries may readily assume, in the presence of formidable figures and charts, that mere increases in net worth, without more, establish a case of unreported taxable income. By the same token, the burden of proof may be wrongfully shifted from Government to defendant, unless the prosecution proceeds with meticulous care and restraint.

Hence, in the *Holland* case this Court established the basic principle that mere proof of increases in net worth is not adequate proof of wrongfully omitted income. In the words of the Court, "requisite to the use of the net worth method is evidence supporting the inference that the defendant's net worth increases are attributable to currently taxable income." *Id.* at 137. "Increases in net worth, standing along, cannot be assumed to be attributable to currently taxable income." However, it may be sufficient for the Government to prove "a likely source, from which the jury could reasonably find that the net worth increases sprang." *Id.* at 137-138.

In the *Holland* case itself the Court cogently indicated the nature of a "likely source" of "currently taxable income." It held that the Government had sustained its burden of establishing omitted income because "the disclosed business" of the defendant "was proven to be capable of producing much more income than was reported and in a quantity to account for the net worth increases," and because of specific evidence of withdrawal of cash which was not disclosed on the defendant's books. 348 U.S. at 138. The Government's evidence revealed that the defendant's business had increased in the prosecution years, that the cash register tapes had been destroyed, and that the books had failed to reflect the receipt of moneys withdrawn for personal expense and business supplies. *Id.* at 139. To the same effect, see also *Smith* v. *United States*, 348 U.S. 147, 158 (1954); *United States* v. *Calderon*, 348 U.S. 160, 165 (1954).

Despite the apparent clarity of the *Holland* opinion the Courts of Appeals disagree whether the Government must establish a likely source of income in the

prosecution period which accounts for the alleged increase in net worth. The Second Circuit has held that a defendant may be convicted under the net worth method without any proof of a likely source. *United States* v. *Ford*, 237 F. 2d 57 (2d Cir. 1956). On the other hand, the First Circuit has held that proof of an increase in net worth, without further proof of a likely source, is not enough to sustain a conviction. *Massei* v. *United States*, 241 F. 2d 895 (1st Cir. 1957); *Thomas* v. *Commissioner*, 232 F. 2d 520 (1st Cir. 1956).[7] This Court has granted certiorari in order to resolve the significant question reflected by the conflict between the First and Second Circuits. See 352 U.S. 1000 (1957); 353 U.S. 964 (1957).[8] In the words of the Government, the question before the Court in *Massei* and *Ford* is whether "in a tax evasion prosecution based on the net worth method, proof of a likely source of the defendant's net worth increases is an indispensable element of the Government's case." Petition for Certiorari, p. 2, in *United States* v. *Massei*, No. 885, October 1956 Term.

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[7] While the *Thomas* opinion dealt with a civil fraud proceeding, the First Circuit held that proof of a likely source of income is "an indispensable element of the net worth method", whether the case be civil or criminal. 232 F. 2d at 526. If persuasive evidence of a likely source is necessary in a civil case, *a fortiori* it is required in a criminal case, where the Government's burden is greater.

[8] The position of the Sixth Circuit, in which the decision below was rendered, is not clear. In the present case Judge Allen holds that a "likely source" exists, but does not indicate whether a "likely source" is essential. In a dissent in *Hasson* v. *Commissioner*, 239 F. 2d 778, 783 (6th Cir. December, 1956), Judge Stewart states that "We have not thought that these words [*re* likely source] in the *Hollana* opinion stated such an absolute injunction." Cf. *Kashat* v. *Commissioner*, 229 F. 2d 282 (6th Cir. January, 1956).

This case presents the same question in a much wider and more common context. The *Ford* and *Massei* cases involve police officers who are charged with evading taxes on bribes. On the other hand the decision below involves the ordinary small businessman. It intimately affects the tax status of innumerable modest entrepreneurs who, in the manner of petitioner, conduct their affairs from day to day largely through cash transactions.

The Court of Appeals has held here that "the jury could reasonably find from this record of exhaustive investigation that a likely source of net worth increase existed in the pawnbroker's business and the Kirschner business with their many cash transactions." Appendix C, *infra*, p. 6a).[9] But as the record plainly discloses, the Government did not offer the least proof that petitioner's businesses were "capable of producing much more income than was reported." *Holland* v. *United States, supra,* at 138.[10] The Court of Appeals simply reasoned that petitioner's books were "not adequate" because of testimony that cash transactions could not be verified from their contents. It then concluded that since the cash transactions could not be verified from the books, the alleged increases in net worth were at-

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[9] The phrase "Kirschner business" obviously refers to petitioner's sales store. After April, 1949, that store was no longer operated in the name of Kirschner. See p. 5, *supra.*

[10] At an earlier point the Court of Appeals states, "The Government also presented evidence of the existence of a current tax source, namely, income from the pawnbroker business, the store, *and substantial income from other sources*" (italics supplied). Appendix C, *infra*, p. 5a. This observation betrays some unfortunate confusion. The Government admitted that petitioner had correctly reported his income from all sources other than the pawnshop and the sales shop. See p. 7, *supra.*

tributable to the businesses.[11] In short, the court below assumed that if a taxpayer has a going business, including cash transactions, an alleged increase in his net worth may be mechanically imputed to the business though there is no proof that the business is "producing unrecorded amounts of income." Cf. *Smith* v. *United States, supra,* at 159.[12] This conclusion is, we submit, irreconcilable with the *Holland* opinion. See 348 U.S. at 126, 128, 138.

The facts of the present case demonstrate the far-reaching effect of the decision below. While petitioner engaged in cash transactions, they were in the ordinary course of his business of selling goods and making loans. There is no suggestion of any strange or unusual transactions. There is no suggestion of false or deceptive entries. There is no suggestion of lost or destroyed books.[13] And the Government fully conceded that the books and returns were in complete accord. See p. 7, *supra.*

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[11] For present purposes we are assuming, which is not the case, that the Government's net worth tabulations are correct. But see p. 20, *infra.*

[12] The Court of Appeals mysteriously says, "While the evidence was in controversy the government, through many witnesses and exhibits, presented evidence of substantial understatement of income for each of the taxable years." Appendix C, *infra,* p. 5a. The only evidence which the Government presented was evidence of alleged increases in net worth. There was no proof that any of the alleged increases derived from the income of petitioner's businesses. See further pp. 16-17, *infra.*

[13] Compare, on the other hand, *Holland* v. *United States, supra,* at 137 (proof of calculated omissions and destroyed tapes); *Smith* v. *United States, supra,* at 158 (lack of records); *United States* v. *Calderon, supra,* at 165 (proof of incomplete, lost, and misplaced records).

Moreover, the Court of Appeals was unduly apprehensive when it observed that petitioner's cash transactions could not be appropriately verified. The Government was scarcely helpless in determining whether any income had been omitted from the books. The cash income of the two stores derived from loans and sales. Each loan was meticulously recorded, as required by local ordinance, and could easily be checked. See p. 6, *supra*.[14] The volume of cash sales could readily be approximated on the basis of petitioner's inventory figures, which the Government accepted as correct (R. 131a-132a). In fact, the revenue agents refrained from examining petitioner's inventory records and loan records, though all were available to them (R. 194a-195a).[15]

So far as "likely source" is concerned, the crux of the matter seems clear. The Government did not produce evidence of a single failure to report income deriving from a loan or a sale (R. 56a, 57a, 142a). It did not make any effort to determine whether petitioners' businesses had the earning capacity which it so freely assumed. It did not offer any proof that the businesses were doing as well in the prosecution years as in the prior years. It did not check the operations of similar businesses (R. 144a-145a) to determine whether petitioner's reported income was markedly different from

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[14] The Court of Appeals overlooks the relevant evidence when it states that "the only record" of the loans consisted of "memoranda" given to the accountant once a month. Appendix C, *infra*, p. 3a.

[15] The opinion below notes, with some emphasis, that "expenditures made in currency" could not be verified from the books. Appendix C, *infra*, pp. 3a, 4a. The emphasis is rather misplaced, for the Government did not charge that any omitted income was concealed by false expense deductions. See note 2, *supra*.

the profits of others. Indeed, the evidence affirmatively indicated that petitioner's enterprise lacked the additional earning capacity assumed by the Government. On March 6, 1947, petitioner reported to Dun & Bradstreet that "net sales and pawn loans have been off considerably so far this year compared with the same months last year." He attributed this decline "to higher prices and less income on the part of customers" (R. 146a; Collective Ex. No. 21 to Davis). In the post-war period through 1952 business continued to recede considerably from the high level reached during the war (R. 166a).[16]

In affirming the judgment of conviction the Court of Appeals has wrongfully relieved the Government from the burden of proving a likely source of income. As a result, the decision below is in sharp conflict with the decision in *Thomas* v. *Commissioner, supra,* as

[16] At the trial the Government showed that the average reported net profit of the two businesses was $34,675.08 for the pre-prosecution years 1945 through 1948, as compared with an average reported net profit of $8,101.31 for the prosecution years 1949 through 1952 (R. 67a-69a; Ex. 10 to Norris, Appendix G(4), *infra*, p. 20a. Through this display of adding and dividing the Government sought to suggest that petitioner must have omitted $26,571.77—the difference between the two averages—in each of the prosecution years. This kind of arithmetic speaks for itself. The Government blandly proceeded on the remarkable premise that since business was good before, it must have been good later. Even on this strange theory, which derives from make-believe as distinguished from evidence, the total alleged unreported income was about $106,000, as contrasted with a total of about $146,000 charged in the indictment. It is not surprising that the court below considered the Government's theory too irrelevant to mention. Cf. *Holland* v. *United States, supra,* at 137, where the Government felt obliged to prove an increase in income for the prosecution years, though the defendants' reported profits were only about 25 percent of the amount declared in a prior year.

well as *Massei* v. *United States, supra.* The *Thomas* case is especially pertinent here. It also involved the prosecution of an ordinary businessman and the First Circuit sternly disapproved what the court below has liberally sanctioned. There, as here, the Government relied on the net worth method of proof. And there, as here, the Government took the view that it is enough if the taxpayer's business "is a possible source of taxable income which could account for the net worth increases." 232 F. 2d at 526. The reply of the First Circuit was precise and to the point. It applies no less here. "We think," the court said, "this argument assumes the very fact to be proved. There must be some independent showing that the corporation might be the source of the unreported income, not merely a negative inference arising from the prior assumption that the increases were taxable and therefore must derive from the corporation since no other taxable source is apparent." *Ibid.*[17] The First Circuit then significantly added:

> ". . . The books of the corporation are admittedly consistent. Of course this does not prove they are honest, but in the absence of some independent evidence to the contrary, we believe that respondent has not indicated a likely source of taxable income. There can be no presumption that the books of the corporation are wrong, for any such approach would render entirely nugatory this particular safeguard against abuses of the net worth method." *Ibid.*

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[17] The First Circuit's opinion emphasizes that in the *Holland* case "the business was proven to be capable of producing much more income than was reported and in an amount sufficient to account for net worth increases." *Ibid.*

The decision below eliminates the vital "safeguard" which the *Thomas* decision carefully preserves in response to the *Holland* opinion. It authorizes a prosecution for tax evasion without any proof that an alleged increase in net worth reflects currently taxable income. And so the decision below raises a critical question which radiates well beyond this immediate case.

II.

In *Holland* v. *United States, supra,* at 132, this Court declared that an "essential condition in cases of this type is the establishment, with reasonable certainty, of an opening net worth, to serve as a starting point from which to calculate future increases in the taxpayer's assets. The importance of accuracy in this figure is immediately apparent, as the correctness of the result depends entirely upon the inclusion in this sum of all assets on hand at the outset." Or, as the Court stated in a companion case, the Government cannot succeed without "proof that assets on hand at the beginning of the prosecution period did not account for the alleged net worth increases." *Smith* v. *United States, supra,* at 155.

In this case the Government has failed to apply the Court's controlling standard of "accuracy" and "reasonable certainty." Its methods of proof, which the Court of Appeals has approved, are plainly incompatible with the safeguards contemplated by the *Holland* decision. As the Court of Appeals' opinion graphically reveals, the Government has been satisfied with a good deal less than the "reasonable certainty" on which the "essential" opening net worth must rest.

The Court of Appeals begins its analysis with an obvious error. It refers to a Government exhibit as indicating that in the four prosecution years petitioner's total expenditures were $368,951.85, while his total reported net income for the same period was $88,169.79[18]—a difference of $280,782.06 (Ex. 8 to Norris, Appendix G(3), *infra*, p. 19a). The Court of Appeals then says, "These calculations, which the jury evidently believed, showed that defendant's private expenditures exceeded his total available income and entitled the jury to find that defendant had large unreported income." (Appendix C, *infra*, p. 6a.)

This holding is incorrect for two reasons. In the first place, as the computation itself shows and the Government concedes, the court completely ignored the fact that defendant had non-taxable receipts in this period of $133,841.81. This amount is shown on the Government's chart as "Non Taxable Income etc." (Ex. 8 to Norris, Appendix G(3), *infra*, p. 19a). According to agent Norris, who prepared the computation, this item consisted of loans and non-taxable types of income "which petitioner is entitled to." (R. 108b). More important, the mere relationship of expenditures to reported income in the prosecution period is meaningless. It takes no account of the crucial factor—the taxpayer's net worth at the start of the prosecution period. If the taxpayer entered the prosecution years with sufficient available funds to supply the difference, the expenditures are easily explained. Cf. *Dupree* v. *United States*, 218 F. 2nd 781, 784 (5 Cir. 1955).

Next the Court of Appeals turns to another Government exhibit which purports to show that from 1920

[18] The court in its opinion incorrectly referred to this figure as being $88,170.19 (Appendix C, *infra*, p. 5a).

through 1948 petitioner's total expenditures exceeded the total reported income of himself and his wife. The exhibit indicates total expenditures of $514,010.90, as compared with total reported income of $484,964.66 (Ex. 11 to Norris, Appendix G(5), *infra*, p. 20a). These figures, the Court of Appeals then concludes, support the finding that petitioner "had some unreported income which was properly attributable to his earnings." Appendix C, *infra*, p. 6a. Once again the Court of Appeals has gone astray. We can reasonably assume that the jury was no less susceptible to error when it appraised the same collection of figures amid a good many others.

To begin with, the exhibit relates solely to pre-prosecution years. It cannot sustain a finding for the years embraced by the indictment. Second, this mode of calculation—which is widely used in net worth cases—is obviously fallacious, unjust, and prejudicial. For example, the computation includes only reported income of petitioner since 1920 and reported income of his wife since 1937. However, in 1920 petitioner was 24 years old (R. 118a-119a); he had been gainfully employed since 1912 (R. 118a); and the evidence shows, without contradiction, that he had already accumulated substantial savings for which the Government's computation gives him no credit (R. 118a-120a; Ex. 11 to Norris, Appendix G(5), *infra*, p. 20a). The Government simply and conveniently assumes a net worth of zero in 1920. Mrs. Epstein was also gainfully employed. The evidence shows very precisely, and again without contradiction, that by 1924 petitioner and she had steadily accumulated savings of $63,500, for which they were given no credit (R. 118a-120a, 123a).

Again, for the entire 28-year period the same computation makes no allowance whatever for non-taxable receipts, especially loans, which are described as "Non Taxable Income, etc." in the previously discussed exhibit. All loans are nicely ignored, though petitioner and his wife were very actively engaged in investment activities (R. 124a). The Court of Appeals attempts to justify this sustained disregard of loans on the basis of a statement by agent Norris. The latter testified that in an interview with petitioner "We talked about gifts, inheritance, loans and items of that type, and he said that he never did receive any or any form of money" (R. 83b). This evidence has a strange ring, for the Government itself introduced an exhibit which contains a lengthy and detailed record of substantial loans, between 1934 and 1948, from the Manhattan Savings Bank to petitioner (Collective Ex. 14 to Davis). Without any explanation the Government steadfastly ignored all loans before 1949, though at the same time it took petitioner's loans in the prosecution years into account in reconstructing his alleged income for those years. See p. 20, *supra*. At the very least, to put it mildly, the exhibit on bank loans indicates that the Government has failed to exercise the "great care and restraint" which this Court expects in net worth prosecutions. *Holland* v. *United States, supra*, at 129. Here, certainly, was a "lead" to which the Government should have been attentive in computing the opening net worth of petitioner. Cf. *id.* at 135. Nevertheless the Government completely disregarded this essential information.

Needless to say, the Government's erroneous calculation—that petitioner had spent more than his income before December 31, 1948—was highly prejudicial to

petitioner. As the Court of Appeals indicates, it naturally induced the jury to believe that petitioner had unreported taxable income. In addition, it wrongfully led to the desired inference that petitioner could not have had a substantial amount of cash on hand at the start of the prosecution period.

We now turn to the Court of Appeals' further analysis and approval of the Government's proof. Despite its reference to Exhibit 11, the Court of Appeals was not too persuaded that the revelations of the exhibit particularly justified the Government's computation of opening net worth. For the court then attempted to state a satisfactory rationale for petitioner's conviction in terms of evidence which it apparently regarded as more pertinent. "A crucial point of the controversy," the court says, "is the Government's calculation of net worth as of December 31, 1948." Appendix C, *infra*, p. 6a. The Government computed the opening net worth as $246,839.63. Petitioner asserted that his opening net worth was $356,695.47. The difference between the two figures turned on the cash on hand as of December 31, 1948. The Government credited petitioner with only $20,000 of cash on hand. Petitioner maintained that in addition his wife had $27,116.02 of her own[19] and he had $82,739.82 accumulated from the Kirschner store (Ex. 5 to Norris, Appendix G(2), *infra*, p. 18a; Ex. 1 to Deutsch, Appendix G(1), *infra*, p. 17a). See p. 9, *supra*. As the Court of Appeals admits, if petitioner's figures for cash were correct, the income constructed under the net worth method "tallied very

[19] The wife's accumulation of cash was significant because petitioner had filed joint returns with her for the prosecution years.

closely" with the income reported on petitioner's return. Appendix C, *infra*, p. 7a.[20]

The Government, of course, must prove its opening net worth computation beyond a reasonable doubt. See *Holland* v. *United States*, *supra*, at 126, 128, 138. With respect to the cash item, it sought to do so by merely relying on various statements made by petitioner. None of these statements involved the critical date of December 31, 1948; none of them purported to

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[20] The court below, on a number of occasions, uses incorrect figures because of confusion in the record. This confusion stemmed from the Government's use, over petitioner's objection, of figures for 1948, as well as for the prosecution years, 1949-1952.

At three points in its opinion the court asserts that petitioner claimed a cash accumulation of $168,000 as of the starting date, December 31, 1948. Appendix C, *infra*, pp. 8a, 11a. This statement is incorrect. The total of $168,000 was the figure claimed by petitioner as of December 31, 1947. Petitioner never claimed more than $129,000 in cash as of the relevant date, namely, December 31, 1948. The larger figure—$168,000—appeared in petitioner's proof only because the trial court's refusal to strike the Government tabulations as to the pre-prosecution year 1948 made it necessary for petitioner to introduce evidence with respect to cash on hand as of December 31, 1947.

The same persistent error appears in the opinion of the court below with respect to the cash on hand belonging to petitioner's wife. The court incorrectly states that the figure of $27,116.02, representing Mrs. Epstein's cash on hand as of December 31, 1948, "was later raised to $63,000" (Appendix C, *infra*, p. 8a). This observation is incorrect. The $63,000 represented Mrs. Epstein's cash on hand as of December 31, 1947, and petitioner showed that she expended the difference between $63,000 and $27,116.02 for investments in the calendar year 1948 (R. 208a). At no time did petitioner assert any figure other than $27,116.02 as representing Mrs. Epstein's cash on the relevant date December 31, 1948.

As we have stated, the Court of Appeals' erroneous understanding of these figures, which apparently seriously influenced its judgment, was due to the erroneous ruling permitting the Government to include on its charts and in its evidence figures with respect to the year 1948, which was not in issue.

include either his wife's cash or the Kirschner accumulation; and none of them was in the least corroborated.

Specifically, the Government derived its figure of $20,000 from statements which petitioner made to a local bank, to Dun & Bradstreet, and to revenue agents. All of them related to the amount of cash which petitioner kept on hand in the active conduct of his businesses (R. 15a, 41a, 77a). None of them remotely dealt with his wife's cash or other assets (R. 78a, 108a-109a, 114a-115a, 141a-142a, 203a-204a). For that matter, the statements to the bank and Dun & Bradstreet were concededly incomplete in regard to petitioner's own assets (R. 108a-113a, 126a, 185a, 24b). Certainly, they did not include the Kirschner accumulation of $82,739.82 (78a, 108a-109a, 203a-204a). As of December 31, 1948, the sales store was still operating under the name of Kirschner, and Kirschner was still filing returns for its income (R. 65a-66a, 129a, 130a, 210a, 84b, 120b). The Dun & Bradstreet reports expressly state that on June 1, 1937, the sales business was transferred to the name of petitioner's "father-in-law" (Collective Ex. 21 to Davis). The president of the bank specifically testified that petitioner "told me at different times that the statements did not include all his assets" (R. 185a). The assets and cash accumulation of the Kirschner business were simply not included in any of petitioner's financial statements.

The Court of Appeals does not even try to justify the Government's refusal to include the wife's $27,116.02 in the opening net worth figure. However, the court attempts to dispose of the Kirschner accumulation of $82,739.82 as follows:

> "As to the item of $82,739.82 cash on hand from the Kirschner store defendant finds himself on the

horn of a dilemma. If during the years in which the Kirschner income accumulated the store belonged to defendant he should have returned this income in his personal income tax. If the store belonged to Kirschner the income received did not belong to defendant and could not be figured in cash on hand as of December 31, 1948, in establishing net worth. Defendant did not explain this situation. The jury was entitled, if it found the store belonged to the defendant, to consider defendant's failure to return the yearly net income of the Kirschner store in his income tax return as evidence of substantial evasion. If the jury found the store belonged to Kirschner it was entitled to disregard the sum of $82,739.82 in the calculation of net worth." Appendix C, *infra*, p. 10a.

The Court of Appeals has discovered a dilemma where none exists. There is no question that petitioner at all times owned the Kirschner store. Throughout the trial it was fully agreed by petitioner and the Government that petitioner, as owner of the store, was taxable on the income which it produced (R. 63a-65a). The trial court instructed the jury, over objection, that it could consider his failure to report the Kirschner income as evidence of willfulness in this prosecution (R. 225a-226a). Moreover, the Court of Appeals has approved this instruction as correct. The court nowhere disputes the evidence that on December 31, 1948, there was a Kirschner accumulation of $82,739.82. And since petitioner owned the Kirschner store, he equally owned the accumulation. The only answer which the Court of Appeals is able to muster is that petitioner should have reported the Kirschner income in his own returns. But this answer is no answer at all. Petitioner is not being prosecuted here for a failure to pay tax on income realized before 1949.

The methods employed by the Government in this case raise a substantial question concerning the meaning and application of the principles so carefully expressed in the *Holland* opinion. Unless these standards are faithfully implemented, they inevitably become vacant generalities. This Court has emphasized the grave dangers which attend the use of uncorroborated statements made by taxpayers to agents in the course of investigation. See *Holland* v. *United States, supra,* at 128; *Smith* v. *United States, supra,* at 152. The present case illustrates that taxpayers may be similarly ensnared through the Government's extravagant use of statements made to others. A businessman who makes a financial statement to a bank for limited credit purposes does not necessarily include all his assets. Certainly he does not normally include his wife's cash or other property; and it is quite understandable that he would not include any assets derived from a business being operated in the name of a relative, especially when the tax returns for that business have been filed in the name of the relative.

The court below reasons that the financial statements made to the bank and Dun & Bradstreet need not be corroborated. Appendix C, *infra,* p. 13a. This conclusion is quite beside the point. In *Holland* v. *United States, supra,* this Court stated that the Government cannot prevail unless it establishes the opening net worth, including the crucial cash figure, by credible evidence carefully presented. It may not rely on evidence that is palpably limited and partial. It may not stubbornly ignore affirmative evidence of other sources of cash accumulations. It may not arbitrarily select an obviously incomplete figure and, in effect, place upon the taxpayer the burden of proving a higher figure.

And it may not seek to support its arbitrary figure by an obviously erroneous computation of the taxpayer's prior financial history. Prosecutors, no less than courts, should be sensitively aware that "bare figures have a way of acquiring an existence of their own, independent of the evidence which gave rise to them." *Holland* v. *United States, supra,* at 128.

Accordingly, we respectfully submit that this Court should review the present case in order to consider the controlling standards of proof in establishing the existence of unreported taxable income and the opening net worth, and to make clear that the prosecution does not carry its burden unless it establishes the opening net worth and the amount of unreported taxable income with reasonable certainty through fair and meticulous evidence.

III.

We now turn to the third question which merits the special scrutiny of this Court.

On the issue of willfulness the trial court charged the jury:

> "... with respect to the separation of what has been referred to in the trial as the Kirschner Sales Store from the defendant's pawn shop, as required by an act of the Tennessee Legislature, that this is a matter you may consider on that phase of the case which deals with the filing of a separate tax return for the sales store and whether or not the defendant in filing a separate return or permitting such a separate filing willfully intended to evade by fraudulent means his just taxes for any given tax year under consideration in this case.
>
> * * *

I might say here, it is not permissible under the tax laws for one who owns more than one business to split or lessen his income tax liability by filing or permitting the filing of a separate return for one of such businesses, even though the return is made out and filed in the name of a third person." (R. 225a-226a).

Petitioner excepted to these instructions, stating that "Kirschner cannot be considered in determining" guilt or innocence in this case (R. 241a-242a).

"A final element necessary for conviction is willfulness." *Holland* v. *United States, supra,* at 139. The Government must establish a specific intent or design to conceal income. *Spies* v. *United States,* 317 U.S. 492 (1943). Here the trial court elaborately charged the jury that on the question of willfulness or intent it was free to consider petitioner's pattern of filing separate returns of the Kirschner income in the pre-prosecution years. The Court of Appeals has approved the instruction. "The jury was entitled, if it found the store belonged to the defendant, to consider defendant's failure to return the yearly net income of the Kirschner store in his income tax return as evidence of substantial evasion." Appendix C, *infra,* p. 11a. In so holding the Court of Appeals has departed from a fixed principle of criminal law.

At this late date it is well settled that evidence of other wrongs, unrelated to the offense charged, cannot be considered in determining the guilt of an accused. *Boyd* v. *United States,* 142 U.S. 450 (1892); and see *Johnson* v. *United States,* 318 U.S. 189, 195 (1943). This principle clearly applies here. The prior separate reporting of the Kirschner income was a

matter wholly apart from the present inquiry into petitioner's alleged willful failure to report income from his businesses. As the undisputed evidence shows, the tax treatment of the Kirschner earnings derived entirely, on the advice of counsel, from a local statute enacted in 1937. Clearly it was not tainted with any desire to conceal income. Indeed, petitioner publicly affirmed, in his statements to Dun & Bradstreet, that the sales store had been formally transferred because of a local statute. (Coll. Ex. 21 to Davis). And when the Tennessee statute which generated the Kirschner transaction was repealed in 1949, the store was promptly placed in his name again and its income was reported on his returns once more. See pp. 5-6, *supra*. Tax motivations were at no time involved.

Evidence of another offense is relevant only if it helps "to establish a criminal plan or design out of which the crime charged has originated." *Lovely* v. *United States*, 169 F. 2d 386, 388 (4th Cir. 1948). But here there is not the slightest suggestion of any such "plan" or "design" which connects the separate reporting of the Kirschner income to the alleged evasion in the prosecution period.

The Court of Appeals' approval of the instruction is in conflict with the First Circuit's view as expressed in *Massei* v. *United States*, *supra*. There the trial

court had charged that evidence of graft in pre-prosecution years permitted an inference of continuing graft in the prosecution years. In reversing the conviction, the First Circuit declared, "It is not a legally permissible inference, absent some reasonable connection, that appellant, having committed a criminal act in the past, continued to do so." The court then indicated that any "reasonable connection" was lacking. 241 F. 2d at 902. Here the alleged connection is even less apparent. In the *Massei* case the conduct alleged in the prosecution years was the same as the conduct shown in the prior years. In this case the alleged intention to evade tax was very different and distinct from petitioner's admitted separation of the pawnshop and the sales shop.

Whether or not petitioner was guilty of tax evasion, he was entitled to a correct charge on the substantive element of willfulness. Cf. *Spies* v. *United States, supra,* at 500. Nor is the principle of law here involved "a mere technical rule of law. It arises out of the fundamental demand for justice and fairness which lies at the basis of our jurisprudence." Parker, J., in *Lovely* v. *United States, supra,* at 389. This principle is peculiarly important in net worth prosecutions, where, in any event, juries can too easily infer guilt. See *Holland* v. *United States, supra,* at 128.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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